Bank Corporate Lending: A Bubble in Progress and Suggested Remedies

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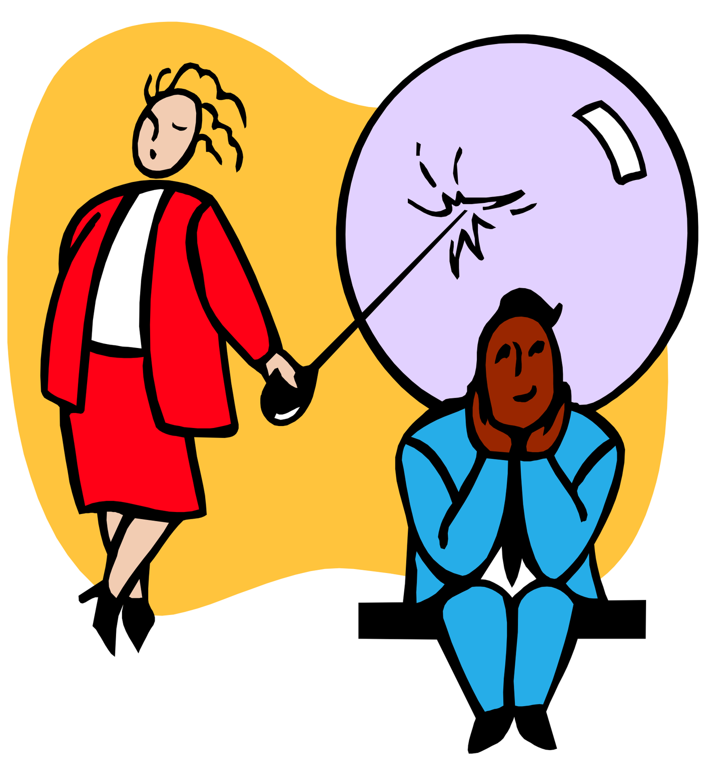
Abstract

The causes of the Great Recession that began in 2008, and the solutions to prevent a recurrence, have been argued over endlessly. The government has responded with various actions: e.g., the Dodd-Frank Act (2010); stronger oversight of the activities of commercial and investment banks; and other measures. A significant unaddressed financial concern are the procedures for bank lending to businesses, which is largely unrestricted as to loan policies, required collateral and other safeguards, and the strength of loan covenants that protect the bank during the duration of the loan. This paper discusses the situation with regard to loan covenants and suggests various remedies.



Introduction

Law and regulation that limit individual and organizational behavior are at the core of our government. With regard to business activity, there is a bifurcated attitude: liberals generally presume that companies are inherently evil, while conservatives often hold that restricting economic activity reduces productivity and wealth creation. The legislative process with regard to business is nearly always reactive as it attempts to prevent the recurrence of a recent disaster

Name your favorite villain: the commercial banks, the investment banks, the traders, the regulators, Congress, federal agencies, and the list goes on. In all of this, the actual culprits are seldom identified. In some cases such as in the case of the housing/sub-prime meltdown, it is because there are many participants, each one of which played a supporting role (Kohn and Sagner, 2014). In other cases it is convenient to blame supposed contributors: financial engineers using derivatives to enhance financial leverage; bankers originating and then securitizing mortgages, and packaging the securities for sale to investors; regulators who failed to adequately do their jobs. Regulation should thoughtfully address the issue of behaviors that should be permitted or forbidden, as well as the metrics and control appropriate to measure and resolve these questions.

Corporate Lending Post-Great Recession

Despite the nearly 370,000 words in the Dodd-Frank Act of 2010, there is a strange silence on corporate lending, which continues to be the purview of various parties. These include bank examiners, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC), and procedures and rules as established by individual banks in the private market.

Corporate lending failures and inadequate participation in oversight by banks and other counterparties played a significant role in the situation. Collapses and near-collapses occurred throughout the U.S. economy. According to the International Monetary Fund (IMF) data, as much as 17 to 23% of debt write-downs in the period 2007 – 2010 in the U.S., U.K., and European Union were comprised of commercial mortgage and corporate loans. The proportion of nonperforming U.S. commercial and industrial loans, and leases, increased more than three times during this period.

When loans have gone into default, banks have sometimes adopted the strategy of "extend and pretend" rather than properly classifying them as non-performing. Bad loans extended beyond their maturity date temporarily prevents a loss, but this obviously does not assist in the timely payment of debt service.

Corporate Lending in 2015

A company currently applying for funding will not know if a loan will be offered, what terms and collateral will be required, how the loan will be monitored, or how the lender will manage a loan in default. A bank in California may offer a loan if the borrower agrees to move all of its financial business to that bank; a financial institution in New York may reject the application; and a non-financial lender (such as a commercial finance company) in the Midwest may offer the loan without further conditions. In other words, this entire process is a "black-box" that can produce a positive or negative outcome for all parties, largely subject to the whims of the lenders.

Assume that we are now at the California bank. The loan documentation will involve a series of warranties, conditions, covenants, pledging of collateral, copies of financial statements, and other material documentation. A naïve borrower may assume that these requirements are standard, but that would be incorrect. Banks design their own requirements, and the entire process can be a "take it or leave it" choice for a small or medium-sized business, or a negotiation for a large company. The customized content in loan agreement covenants depends on the bargaining power and characteristics of the borrower and the lender in each contract.

Contents of Loan Covenants

Bank lending to corporations traditionally involves covenants that require a debtor to meet specific measures of financial and operational performance. For example, the borrower must achieve earnings above a stated multiple of interest expenses; the current ratio (current assets divided by current liabilities) must be maintained in excess of a specified amount; and restrictions may be imposed on future borrowing by the corporate. These and several other positive and negative covenants provide the creditor with some assurance that the debtor is retaining its capacity to service its debt.

A decline in debtor performance can force a loan restructuring, the seizure of collateral, or other remediation. Covenants act as surveillance and control in lending situations, providing an opportunity for creditors to work with borrowers before the situation leads to a default, a bankruptcy or other dire outcomes. However, covenants impose costs: restrictions may be too restrictive and may constrain the borrower's flexibility to take necessary actions in response to business opportunities or threats. Debt contracts vary over time between traditional covenants and "covenant-lite" (sometimes referred to as "cov-lite") versions that impose minimal restrictions on borrowers.

Cov-Lite Loans

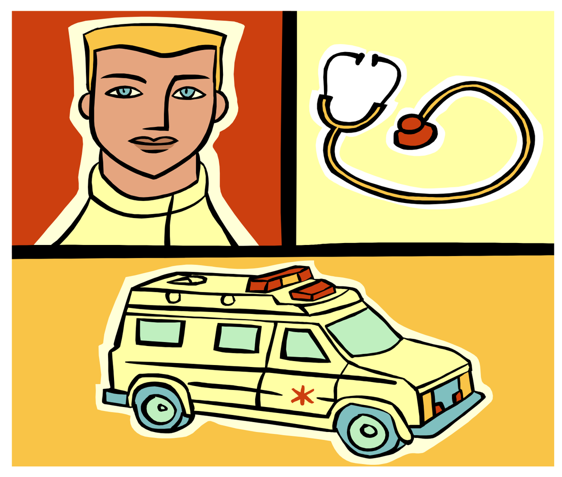
The term "covenant lite" as defined by a leading credit rating agency refers to loan agreements with incurrence covenants, which are those tested when a borrower takes an action that is limited by the covenant. Covenant-lite loans represented 57% of total bank loan issuance in 2013 and now constitute nearly half of the bank loan market.

Covenant-lite deals became increasingly common through the first decade of this century. Market observers attributed this to an excess supply of credit. The market for covenant-lite loans collapsed in the second half of 2007, and a period of tighter and more extensive covenants followed until 2009. Covenant-lite deals then resurfaced, at least for higher-grade borrowers, because of an excess supply of bank funds.

According to Standard & Poor's, "… growing investor demand from structured finance vehicles and hedge funds, have allowed bank facilities with weakened 'covenant-lite' loan structures to emerge as the instruments of choice for many issuers. As the volume of leveraged loans reaches an all-time high, the proportion of covenant-lite facilities has increased tremendously...."

Fewer Covenants = Riskier Loans

In a private market setting – albeit with regulatory supervision – fewer loan covenants in bank credit agreements have become an inevitability. The movement of loans off of bank balance sheets (techniques are noted below) weaken the motivation of an originating bank to monitor borrower performance, resulting in less rigorous oversight across dispersed creditors. This situation can only result in continued credit "bubbles" and a repeat of the cycle of loans to marginal corporate borrowers, inadequate credit review, the dispersal of loans to investors and other banks, and government rescues.



During the 20 year period from 1995 through August 2014, the average number of FDIC failed and assisted banks was 28.5; in the worse years of the Great Recession – 2008-2011 – the numbers of FDIC fails and assists was 148, 154 and 92 respectively, or some 4½ times typical experience, with FDIC losses of $81.67 billion.

What can go/will go wrong? Financial statement data can be manipulated by many techniques; see the full paper for situations that involved the use of earnings, financial leverage and liquidity results as reported on public company financial statements. Although GAAP is considered as the foundation of financial reporting, significant latitude is permitted in the calculation of financial statement accounts.

Conclusions

This paper argues that the most glaring omission from the remediation following the Great Recession banking and housing collapse has been in corporate lending. Loans to businesses constitute a significant portion of a bank's revenue, yet much of this activity is conducted in the private market and beyond the close monitoring of the regulators.

The safeguards that are now in use are inadequate to provide the protection that banks (and their depositors, stockholders and the public) require. Covenants are satisfactory when the originating bank(s) maintains oversight of the loan and keeps "skin in the game". The use of securitizations, loan sales and covenant-light agreements, as well as inadequate requirements for collateral, do not begin to offer adequate restitution or minimal protection should the borrower encounter business difficulties.

The solution is for the regulators – perhaps through an amended Dodd-Frank Act – to require that banks include in lending agreements a sufficient number of rigorous covenants to clearly understand the performance of the corporate borrower in the attempt to minimize the likelihood of deception. A few financial statement accounts in covenants can certainly be manipulated; it is considerably more difficult to influence results throughout a comprehensive set of covenants based on the status of the business, the income statement and the balance sheet.

Critically important covenants could be mandatory while others could be suggested, particularly as some metrics are industry specific. Twelve proposed covenants for inclusion are included in the paper, which is certainly more than the number found in a cov-lite loan agreement. Each suggested financial ratio can be compared longitudinally (to previous years' results) and crosssectionally (to industry results).